The Long & Short of It

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Flood

For the past 60 years, the post-World War II baby boom generation has been the primary determinant of economic growth and interest rates in the US economy. As they went to college, joined the workforce, created popular culture, flooded the housing market, and had children, the boomers fueled massive growth of aggregate demand that led to the inflation of the 1970s and 1980s. This demand-driven inflation was difficult for the Federal Reserve to staunch. The Fed often tightened monetary policy beyond what was thought possible, but growth and inflation would continue and interest rates would just move higher. If inflation relented even a little bit, the slightest relaxing of monetary policy would just result in more inflation.

Drought

Today, retiring baby boomers continue to make their mark—in reverse. They serve as a drag on the economy as low interest rates, large amounts of debt, and deflation trail in their wake. In direct contrast to the 1970s, the Fed's stimulative monetary policy is rather ineffective and its restrictive policy often too impactful. The unprecedented post-crash stimulative policy of 2008 to 2018, including zero-percent interest rates and quantitative easing, accompanied the lowest growth recovery in US history. Talking points among Fed watchers (and, embarrassingly, among some of the Fed governors) are that the Fed has become ineffective, impotent, and even irrelevant.

Normal vs. Inverted

Until some other tool replaces the Fed, it is useful to study the current economic landscape—specifically today's interest rate environment. The interest rate on a fixed income instrument (e.g., overnight loans, 30-year maturities, AAA bonds, junk credits) represents an investor's best estimate of the future growth of the economy, a corporation, or a municipality over various time periods and levels of risk. At the simplest level, interest rates are an estimate of future growth. Interest rates and growth rates therefore tend to move together and are inseparable over the long run.

The yield curve, also known as the term structure of interest rates, is a graph that plots the yields of similar-quality bonds across different maturities. A normal yield curve is upward-sloping, with longer-maturity bonds offering investors a higher interest rate than shorter maturities due to the inherently greater risk of a longer time to maturity. An inverted yield curve indicates the opposite, an unnatural distortion with shorter maturities paying more than longer ones. Inverted yield curves are usually caused by restrictive monetary policy.

Since 1950, all nine major US recessions have been preceded by an inversion of a key segment of the yield curve. In the third quarter of 2019, the yield curve inverted significantly, reflecting a new level of tightness in monetary policy not seen since mid-2006 to mid-2007 or the second half of 2000. Prior recessions during periods of solid growth (as in the 1970s and 1980s) were preceded by an inverted yield curve. Our current economy is much weaker and therefore unlikely to be able to resist a recession.

Not Immediate

There is a roughly one-year delay between the date monetary policy is announced and its "peak impact." This is a leading source of confusion among pundits, the media, and investors because the markets react instantly to a change in policy but with imperfect foresight. The reality of that change will actually take a year or longer to unfold.

In addition, there is much debate about what is more impactful for monetary policy: the absolute Fed funds rate or the state of the yield curve (normal vs. inverted). Today, the yield curve is still inverted despite two recent reductions in the Fed funds rate.

Let's consider two scenarios for evaluating our current economic climate. In the first, let's assume the Fed funds rate (and the general level of interest rates) is the primary aspect of policy. If so, then the Fed has already begun to stimulate the economy and things should look better in a year. For the second scenario, let's assume that the yield curve's term structure is the primary determinant of policy. In that case, the Fed is firmly standing on the brakes of an already weak economy. One year from now would look bleak as we head into the election. Historically, the Fed tries to remain neutral during most election years but in some circles, this potential weakness would spark cries of

a conspiracy to stop Trump from being reelected. However, we believe it would simply reflect that the Fed fails to appreciate the asymmetric effectiveness of its powers and also the powerful undercurrent of retiring boomers.

Can Washington Stem the Tide?

Increased economic growth is typically a good thing for politicians as it creates increased tax revenues available for fiscal programs. But with Uncle Sam stooping under his heavy debt load these days, economic growth is not the panacea it used to be. Greater economic growth leads to higher interest rates that hinder the government's ability to borrow more money. Slower economic growth means lower tax revenues but also more ability to borrow and spend due to even lower interest rates. If politicians seem a bit ambivalent about private sector growth, it may be because higher growth rates bring higher interest rates that, in turn, reduce discretionary moneys available to politicians.

In the coming recession (whether imminent or not), the government's ability to issue treasuries to cure the ills of a private sector credit contraction will be much lower than in the last recession. The Fed will be more innovative and creative, if not with monetary policy, then with new and creative euphemisms used to describe the traditional approach to solving such problems—historically referred to as "printing money."

How to Smooth the Waters

Nothing in the demographic data suggests a shift away from baby boomer influence until 2025-2030, so the near future likely holds greater levels of debt, lower growth rates, and possibly negative interest rates.

In a low interest rate environment, stocks of companies that demonstrate reasonable per-share growth can carry extremely high valuations. The only caveat is their balance sheets. Companies that carry too much debt can see their stock prices punished when revenues or stock markets turn down. At Robinson Value Management, we analyze the balance sheets and credit strengths of these companies to minimize risk.

In a recession, unproductive assets such as precious metals typically do well over the near term (two to three years). However, gold and other precious metals are not great investments over the long term (10 to 20 years). We therefore use gold tactically to offset downside volatility in the portfolio by leaning into or away from it as dictated by our research. In addition, some defensive posturing by way of a tactical allocation to cash can provide additional ballast to the portfolio.

In conclusion, solid stocks that avoid undue risk and are built to endure provide the best means of growing your portfolio. These companies are often not flashy or pretty, but several years later you will be pleased to see your saplings growing tall all along the river.

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